Enterprise Risk Services

Risk Management Brief

Reputational risk management is one of those risks that are hard to measure, even though it should be addressed in the ICAAP process. Nevertheless, it deserves a comprehensive risk management framework.

by Mathias Christiaens, 9 September 2008

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."
— Warren Buffet

Managing Reputational Risk

Why reputation matters

Several surveys confirm that reputational risk has emerged as a major concern for many executives and risk managers, not only in the FSI industry. The increase in reputational risk is for the most part attributable to the increasing dominance of intangible assets. In today's economy, intangible assets such as brand, intellectual capital, strategic relationships and the 'licence to operate' account for 70% to 80% of a company's market value[1]. This is certainly the case in the financial services industry where the ability to underwrite new business is heavily reliant on the standing of the reputation of the firm, a fact that was dramatically underscored in this year's takeover of Bear Stearns.

Despite the increased awareness for reputational risk, most (if not all) organizations will admit that they struggle to manage this risk. This brief defines the notion of reputational risk, discusses its key drivers and develops a high-level reputational risk management framework.

Defining reputational risk

An important obstacle in the management of reputational risk lies in the absence of a commonly accepted definition thereof. The Basel II Accord recognizes the existence of reputational risk but does not define it. It simply states that it is excluded from the definition of operational risk, but includes it in the scope of risks to be considered under Pillar II.

The Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) has defined reputational risk as follows[2]:

> "The risk of potential damage to an undertaking through deterioration of its reputation or standing due to a negative perception of the undertaking's image among customers, counterparties, shareholders and/or regulatory authorities."

CEIOPS goes on to say that reputational risk should be regarded as less of a separate risk, than one consequent on the overall conduct of an undertaking. Similarly, The Economist Intelligence Unit referred to reputational risk as "the risk of risks"[3]. Indeed, each credit, market or operational loss event has the potential to harm your organization's reputation as a second order impact. What's worse, the damage inflicted to a firm's reputation could well prove to be more significant than the first order impact, the underlying loss itself.

A striking example is Northern Rock. The origin of the bank's problems presumably lay in its inadequate liquidity risk management. It failed to address its dependence on money market funding, which dried up in the context of the global credit crunch. This problem, however, was addressed when the Bank of England provided a liquidity support facility, helping the bank to fund its operations during the period of turbulence in financial markets whilst the bank could take the required actions to resolve its structural problems. At the end of the day, however, the bank was not affected as much by its liquidity problems as it was by the erosion of consumer confidence (remember the headline pictures of people lining up on the streets waiting to withdraw their funds). The bank run initiated a vicious circle of ever increasing liquidity problems. In the end, the reputational damage was to blame for the downfall of the bank.

Notwithstanding the fact that the majority of reputational damage can be described as a second order impact, a number of reputational risks can nevertheless be classified as 'independent risks' meaning that reputational damage could be considered as a first order impact. These independent risks can often be associated with ethics. Organizations that do not abide by high ethical standards and that ignore principles of market conduct are vulnerable to losing their customers' trust and confidence. In short, each organization has a social responsibility that it cannot ignore and that it must address in its corporate governance.

Linkage between capital adequacy and reputational risk

A fiercely debated topic is whether a financial institution must consider foreseeing capital for reputational risk.

Naturally, setting aside capital to absorb unexpected losses attributable to reputational damage requires a quantitative risk assessment. For reputational risk, such quantification will prove to be difficult due to a lack of generally accepted measurement methodology. In anticipation of a market consensus hereon, many firms are currently arguing that the assessment of reputational risk is above all a qualitative assessment based on expert judgment.

This point of view seems to be supported by the Committee of European Banking Supervisors which has stated that setting a capital requirement is only one tool made available by the CRD[4]. Supervisors recognize that while capital has an important role to play in the mitigation of risks, it may not always be the sole or best solution to mitigating risk. For less quantifiable risks (such as reputational risk), the focus of the ICAAP could indeed be more on a qualitative assessment, risk management and mitigation.

Whether financial services firms have quantified their reputational risk or not, it seems fair to conclude that supervisors will expect all financial firms to be able to demonstrate that they have implemented a comprehensive set of procedures and internal controls aimed at reducing reputational risk to a minimum.

Does this mean that quantifying reputational risk is a useless effort? No! On the contrary, the ability to quantify reputational risk is helpful in prioritizing and presenting the sources of reputational risks to senior management. A firm that is able to combine the best of both worlds, i.e. being able to understand its exposure to reputational risk through quantification and being capable of dealing with the risk through reputational risk management has a clear competitive advantage.

Managing reputational risk: prevention is the best remedy

Effectively managing reputational risk can be achieved by applying the well-known framework of identification, assessment and management.

Identification

A prerequisite enabling a firm to identify potential events that may negatively affect its reputation is acknowledging that reputation is owned by the stakeholders.

Every organization has a multitude of stakeholders: investors, customers, employees, management, board of directors, regulators, suppliers, the community in which the firm operates, etc. These stakeholders have an array of expectations covering different aspects of corporate performance.

Customers	Suppliers
• Product quality, value • Service • Trust, respect	• Volume of business • Sound management & operations • Financial stability
Employees	**Regulator**
• Pleasant workplace environment • Fair compensation, knowledge building • Equal opportunities	• Timely reporting • Sound corporate governance • Transparent communication
Investors	**Community/Society**
• Return on investment • Earnings growth • Regulatory compliance	• Community involvement • Fair treatment of people • Respect for environment

A firm's reputation is determined by how the stakeholders perceive its performance in each of these aspects. The reputation is at risk as soon as expectations of the firm's performance exceed underlying reality. In order to avoid damage to its reputation, the firm should try and close the gap by either improving performance or by managing the expectations down to the more realistic levels.

Failure to take actions aimed at closing the expectations gap will be detrimental. Sooner or later, the inability to perform in accordance with the stakeholders' expectations will be revealed. Not only will the organization then face severe reputational damage, it could also find itself at the other end of the pendulum, with its reputation falling short of its actual performance. In other words, any realisation of the classical risk categories is likely to give

information on the company's performance in the light of prevailing expectations. Hence our earlier assertion that reputational risk is a second order risk.

Closing the expectations gap, however, could in itself expose the organization to reputational risks. If, for example, the performance of a firm fails to meet investor expectations, management could be tempted to stray towards unrestrained market performance to increase its financial performance (e.g. market share, earnings growth, ROI, etc). In taking these actions, however, management should always keep in mind that it should continue to abide by its ethical standards. Actions such as aggressive selling could perhaps decrease the gap with investor expectation, but are likely to increase the expectations gap with customers who might lose their trust and respect. Balancing between the different stakeholder expectations is one of the main challenges of reputational risk management.

Once the stakeholder expectations have been identified, the organization should make an effort to identify the incidents that, should they occur, would fall short of these expectations and therefore damage the firm's reputation.

The following techniques can be used to identify both stakeholder expectations and potential reputational events:
- Media analysis (television, newspapers, magazines, blogs, message boards, etc)
- Interviews with front-line employees (i.e. those employees that are frequently in contact with suppliers, customers, investors, bankers, etc and are therefore well aware of the issues raised by these stakeholders)
- Brainstorming with management
- Industry research.

Due to the dynamic nature of stakeholder expectations, this step must not be viewed as a one-off effort. Every organisation must continuously monitor changes in the stakeholder expectations.

Assessment
Having identified the events that could damage the firm's reputation, each event needs to be assessed in terms of the likelihood that it will occur and the severity of the reputational damage which may result if it occurs.

Risk rating scales can be used both for the assessment of likelihood and severity. The table below is a simplified approach.

Likelihood		Severity	
High	Likely to occur at least once per year	High	Regulator, clients, public opinion impacted, loss of clients
	Likely to occur once every few years	Medium	Regulator or client impacted, few clients lost
Low	Very remote probability of occurrence	Low	Regulator or client impacted, no clients lost

When combining the likelihood and the severity, a risk score is obtained. This score can help to prioritize the risks and to aid in decision making.

Likelihood	High	Medium	High	High
	Medium	Low	Medium	High
	Low	Low	Low	Medium
		Low	Medium	High
		Severity		

In addition to a qualitative assessment, firms could also opt to perform a quantitative assessment of their reputational risk. The objective of such quantitative assessment is to measure the impact of reputational damage in terms of reduced operating revenues due to loss of clients, increased compliance and other costs to restore confidence, and perhaps the increase in the cost of capital as a result of the reputational event.

An array of techniques exists, varying from straightforward to complex. Examples of techniques include:

- Examining a firm's stock price reaction to the announcement of a major operational loss event. If the firm's market value declines by more than the announced loss amount, this is interpreted as a reputational loss[5]
- The actuarial approach, whose focus is the loss distribution. Frequency and loss severity are modelled separately and then aggregated using either Monte Carlo or numerical techniques

Whilst quantification is arguable as much an art as it is a science, we believe quantification is useful even where there are large uncertainties. It contributes to intelligent decision making and makes the risks even more tangible. Naturally, decision makers should continue to give due consideration to factors that defy quantification and that are thought to be important.

Management
The ERM Integrated Framework proposed by COSO defines four risk responses:
- Avoiding
- Accepting
- Reducing
- Sharing

Avoiding risks that can cause reputational damage is far from obvious since these risks are often embedded in the core of the business. A classic example, however, of a risk that can be avoided is the reputation risk linked to mergers and acquisitions. When making strategic investment decisions, management should look into the litigation, regulatory and compliance history of its target. Targets that engage in wrongful conduct are often better avoided to prevent reputational damage to the acquirer. Another example is the risk of mis-selling, a risk that can be avoided by being less aggressive on sales targets.

Accepting certain reputational risks is a strategy that must be implemented with great care. This links back to the fact that expectations can, and do, change over time. Take the example of oil companies in the previous century. During many years, little attention was paid to environmental issues. Whilst behaviour such as oil spills was criticized in the media, it was not sanctioned. Consequently, companies in the oil industry accepted the risk of a spill. Then, suddenly, a large oil spill in 1969 ignited an environmental movement resulting in stakeholders to raise the bar, expecting all organizations to strengthen their environmental efforts. Companies that failed to do so and continued to neglect environmental concerns suffered important reputational damage.

Reducing reputational risks through preventive and detective control activities is the most likely and often the most appropriate response. Control activities should be designed such that they reduce as much as possible the first order risks (e.g. operational risks).

In the context of reducing reputational risks, the importance of corporate governance deserves to be highlighted. Firms should articulate, disseminate and enforce an ethical code throughout the business. Employees at all levels of the organization should be well aware of the risks and events that could affect the firm's reputation. The objective should be to develop and reinforce a true risk management culture in which compliance is put on top of the agenda.

Sharing risks in the context of reputational risk management is rare, and not recommendable. By nature, reputational risk is not something that can be legally transferred. Therefore, firms must be aware that they can even suffer reputational damage as a result of actions taken by others. A good illustration of this is the effect of the market distress that began in the second half of 2007. Banking organizations under no contractual obligations provided voluntary support to ABCP conduits and other off-balance sheet financing vehicles, including structured investment vehicles (SIVs), because of concerns about the potential damage to their reputation and to their future ability to sell investments in such vehicles if they failed to provide support during the period of market distress[6].

The overall aim of managing reputational risk should be to close the gap between the stakeholders' expectations and the true performance of the organisation. This links back to the observation that reputation is at risk as soon as the expectations exceed reality. Should an organisation identify an expectations gap, it needs to either lower expectations (through communication) or increase performance (through operations).

Preparing for the worst: developing a crisis response strategy

Evidently, no matter how well-developed the risk mitigation tools in place (crisis prevention), no firm can fully avoid being exposed to reputational risk events. This leads us to the importance of crisis management, aimed at minimizing the damage caused by such events. Being able to respond effectively to crisis events is likely to prove to be a much more efficient means of mitigating reputational damage than (just) setting aside capital. Therefore, it is best practice for firms to develop a crisis response strategy. Such a strategy would typically include at least the following elements:

- Identify a crisis response team for which the roles and responsibilities are clearly defined
- Prepare draft versions of internal and external communications with all key stakeholders
- Ensure fast access to relevant data that the crisis response team will need to make its decisions
- Simulate crises in order to test the crisis management plans

This last point is often overlooked. Having a crisis management plan is a good first step, but it will only become useful once it is tested through simulation exercises. Simulating a crisis enables errors to be identified and addressed and lessons to be learned. Unfortunately, crises will rarely happen as envisioned during the simulations. Therefore, the crisis management plan should be flexible enough and the people in charge of executing the plan must have the ability to adapt accordingly.

Conclusion

Whilst many organizations are aware of the importance of reputational risk management, only few organizations have implemented a true reputational risk management framework. The main challenge is recognizing the need for a focused approach and assigning one person with the responsibility to execute this. When done properly, the benefits will far outweigh the costs and the organization will be assured that its most important intangible asset is well protected.

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